Welcome Back, Mr. Bond
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by Jeffrey Saut
of Raymond James

“We’ve been expecting you Mr. Bond.” The phrase is itself a variant and joins the phrase “Play it again Sam” as a phrase attributed to a film or TV series. I have used said quip over the past few years, having been wrong-footedly expecting a backup in interest rates. While I did finally target the yield low of last July, the ensuing rate rise has been far slower than I would have thought, that is until the past few weeks. Obviously, Ben Bernanke began accelerating the rate-ratchet in May with a concurrent downside reversal in the S&P 500 (SPX/1592.43) on May 22nd, as well as a dramatic upside reversal in the Japanese yen. Those events triggered an unwinding of the Japanese “carry trade” whereby hedge funds borrowed at low interest rates in Japan (in yen), converted those yen into dollars, and bought high dividend-paying stocks using leverage (Utilities, REITs, MLPs, etc.). As long as those “high payers” were going up, and the yen was going down, the hedgies were getting a double kick on their positions. However, when the yen began to rally versus the dollar, and the “high payers” began to fall, those leveraged positions started to lose a lot of money, causing them to be unwound and unwound quickly. The result was a roughly 14% loss in the D-J Utility Average (UTIL/471.77) since its April 30, 2013 intraday high into last Friday’s intraday low. Most of the other “high payers” suffered similar losses, if not more.

Obviously, things accelerated to the downside with Ben Bernanke’s FOMC statement last Wednesday. As our economist, Dr. Scott Brown, wrote:

“In his press briefing following the June 19 FOMC meeting, Fed Chairman Bernanke outlined how the evolution of the economic outlook will drive policy decisions in the months ahead. The key messages are that monetary policy will remain ‘data dependent,’ that tapering is not tightening, and that higher short-term interest rates are still a long way off. The markets have focused on the expected timing of the step down in asset purchases, but whether that happens a few months earlier or later shouldn’t really matter. Either the markets are misinterpreting what Bernanke said, or the markets were badly mispriced to begin with."

I agree with Scott’s thinking. Bernanke was very clear in saying that whatever direction the Fed takes it will be “data dependent.” If the economy slows it likely means no tapering. But all the equity markets “heard” was, “Interest rates are going up,” even though that is not what Bernanke said. However, the best “orphaned” Treasury paper out there, and therefore the one with the best forecasting ability because it is a “free market trade,” is the 5-year T’note; and, its yield has risen 117.3% (0.649% to 1.419%). So, the 5-year T’note is “expecting” interest rates to go up, and to go up a lot. Accordingly, I think it is doubtful Bernanke is going to “taper” any time soon. As for Scott’s comment about the stock market being “mispriced,” I offer this email from a very bright Virginia Beach-based portfolio manager:

“I don’t get it. All these ‘experts’ on CNBC have been saying that ‘the Fed buying is almost solely responsible for the rise in stock prices over the past four years.’ But, at the March 2009 lows the S&P 500 was at 666 with $49 of earnings, giving it a P/E of 13.6. If 2013 earnings come in at the estimated $110, then at 1590 the S&P 500 sells at a 14.4 P/E. Some alleged ‘expert’ just said, ‘That’s asset inflation.’ But back at ’E ver F lexible Hutton,’ you and I saw the market’s P/E go from ~8 in August of 1981 to a P/E of 27 in August of 1987. THAT is asset inflation! The analogy I have been giving to my clients is: ‘What costs more, a 1-pound can of coffee for $1 or a 3-pound can of coffee for $3? If you are talking about total price, well then the 3-pound can of coffee costs more. But if you’re talking about how much you get for what you are paying, they both cost about the same. That’s kind of how I view the market here. Am I nuts? Well, let me rephrase that question, am I nuts using this analogy? Of course I am nuts, as are you! Anyone who has chosen to make a living doing what we do is most definitely nuts.”

I liked that email because I think it speaks to one of my mantras, “The difference between perception and reality is where our opportunities lie.” Of course that raises the ubiquitous question I received following last Wednesday’s press conference, “Is this the ‘meaningful decline’ you were targeting for July?” My response was, “I can’t really tell because Friday is a quadruple witching session with options, futures, indexes and stocks all expiring on the same day. Around such witch
twitches anything can happen and market movements tend to be amplified. So, it will take until Monday/Tuesday of next week before I can tell if this is the ‘meaningful pullback’ I have been targeting to begin in July.” That said, Wednesday and Thursday of last week proved to be back-to-back 90% downside volume days. Recall, it was the back-to-back 90% upside volume days of 12/31/12 and 1/2/13 that began this “buying stampede,” which still has not ended because we have yet to see four consecutive down days for the D-J Industrial Average (INDU/14799.40), making today session 120. Plainly that begs the question, “Did last week’s back-to-back 90% downside volume days end the stampede?” While the history of back-to-back Upside Days has led to abnormally positive returns most of the time, the history of Downside Days is not as consistent. Sometimes such days are followed with a “buying surge” like was seen following the 90% Downside Days of 10/31/11 and 11/1/11, which led to the undercut low of 11/4/11 that I continue to think was the “valuation low” for the SPX. A year later shows only one negative return, since the year 1950, with an average one year gain following such 90% Downside Days of almost 24%.

Turning to the charts, obviously it is disconcerting the SPX has fallen below its 50-day moving average at 1618.23 (see chart on page 3). That caused some technical analysts to suggest the next objective is going to be the 200-DMA around 1506. I would remind those folks that at 1506 the SPX would again be trading the P/E ratio my portfolio manager friend spoke of coincident with the March 2009 low. Interestingly, looking at the daily chart of the SPX (chart 1) makes the recent decline seem pretty ugly; however, looking at the monthly chart (chart 2) shows the decline to be merely a blip. As stated, the first part of this week should decide if we are going to spill over into a full-fledged correction. My best case scenario would be for the SPX to trade back above 1618 (its 50-DMA). If it can do that, then I think the mid-July downside timing points remain in force. The next few sessions should tell us.

The call for this week: “Welcome back Mr. Bond, we have been expecting you,” except in all candor, I have been looking for an interest rate “low” for the past two years. I finally got the secular “low” right targeting last July (2012) as the “low water” mark in Treasury yields. Accordingly, for over two years I have been telling accounts to be VERY careful with the fixed income component of their asset allocation. My vehicle of choice has been the Putnam Diversified Income Trust (PDINX/$7.78), which in fair disclosure I own, and currently yields 5.6% (taxable) with zero yield duration. While this month’s figures are as of yet not available, I can tell you that PDINX was up 1.36% in the month of May, and at the end of May was up ~5% YTD. The quid pro quo is that the 10-year T’note’s yield was up about 53 basis points and its price was down 3.75%. Meanwhile, the Barclay’s Aggregate Bond Index lost 1.74%, and was down ~1% YTD, as the 10-year Treasury’s yield leaped from 1.63% on May 2nd to 2.17% on May 28th. During that same timeframe PDINX was up 1.36%, and was better by ~5% YTD. Interestingly, the yield on the 10-year Treasury note currently resides at 2.51%, which I think is over done on the upside on a short-term trading basis. Yet, I think the battle between the “bulls” and the “bears” will be fought over the next three sessions. Unfortunately, I will be on the West Coast seeing accounts, and speaking at events, so be careful out there!

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